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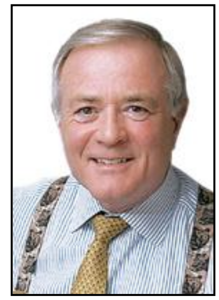

William Rutherford

Stocks enter new era; with new sheriff comes new outlook

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The year 2016 started poorly, with the market dropping more in January than any other time in history. The equity market struggled throughout the year, continuing a trend which saw the S&P gain 1.9 percent from the end of 2014 through the first half of 2016. The California Public Employees Retirement System, the largest public pension fund in the U.S., with all its access to the best investment advisors, gained only 0.06 percent for the trailing 12 months ending June 30, 2016.

It's no wonder that investors were unhappy with returns. They flocked to low-cost index funds in the belief they were better off, as low interest rates and no-growth policies sucked the gains out of the markets. Once interest rates start to rise and earnings return to the markets, stock pickers will regain the upper hand.

Fixed-income markets, coming off a 35-year bull market, saw massive drops after the election and two trillion dollars in market value in bonds was lost. So much for "low risk" fixed-income investments. Despite the poor performance of the equity markets, they were still the best place to be.

Everything appeared to change with the presidential election. With the Republicans retaining the House and Senate and claiming the White House, a pro-business outlook appeared to be winning the day. Visions of tax reform, fewer regulations and a business-friendly environment filled boardrooms and small businesses across the country. The market jumped nearly 7 percent by the end of the year.

It also helped that the Federal Reserve raised interest rates by a quarter-point and hinted at more rate increases in 2017. Corporate earnings in the third quarter had jumped 3.1 percent from a year earlier, entering positive territory for the first time since the first quarter of 2015. Estimates for the fourth quarter of 2016 were for earnings growth of 3.2 percent. Forecasts are for an earnings increase of 4 percent in 2017.

Still, there are many obstacles to this rosy forecast. It is uncertain how much of the Republican agenda will pass Congress. It is uncertain how much the president-elect's policies will be constructive for the economy, as he seems to be at war with the market, the economy, other sovereign states and sometimes his own party.

The markets do not like uncertainty. Indeed at the Federal Reserve meeting held Dec. 3-4, 2016 and in minutes released Jan. 4, 2017, the Federal Reserve expressed "considerable uncertainty" in the new administration's policies. It said the uncertainty would make it more challenging to communicate its plans for the path of interest rates. Chairwoman Janet Yellen emphasized the "considerable uncertainty" about possible policy changes that the incoming administration and new Congress may support, their potential economic effects and what they will mean for monetary policy. Those changes will have to be factored into the Fed's forecasts eventually. "We're operating under a cloud of uncertainty at the moment," she said.

This year I expect more rate hikes, perhaps as many as three. Rate hikes will be positive for financial stocks, which were a leading sector for the market last year. Energy should do well if the price of oil stays above $50 a barrel, and even better at $60 a barrel; even marginal producers should make money at that level. The president-elect's intent to borrow a trillion dollars over the next 10 years for massive infrastructure spending has already caused a rout in the bond market with two trillion dollars in value wiped out. Losing $2 trillion of pensioner money for a $1 trillion infrastructure program, no matter how badly needed, does not seem to make sense. Nevertheless, even the announcement was inflationary, and the doing is expected to add to inflation. Expect more interest rate hikes.

Higher rates will mean a stronger dollar. That is good if you are traveling to Europe or Canada, but not so good if you are a company selling into those markets. Expect lower sales for the companies that do, and perhaps layoffs.

Tariffs are another proposal of the president-elect. This talk has already caused a rethinking and shifting of investments. Billions of dollars of value have been wiped out of various companies and industries that the president-elect has attacked. Investors have felt the sting. His attacks on Mexico and threats to build a wall have led the Mexican peso to drop 10 percent. Now it just makes that much more sense to move manufacturing to Mexico and that much harder to sell to a country with which we share a border. Not surprisingly, if Mexicans have jobs at home, they will tend to stay in their own country, and since NAFTA took effect, more have been staying home and not migrating to the U.S. Many of the immigrants that the president-elect complains about are not Mexicans, but rather refugees from political and economic turmoil in Central America.

Last year, consumer discretionary and consumer staple stocks were among the worst-performing sectors. Together, these companies comprise over 70 percent of the U.S. economy; their performance was certainly a drag on the markets. One can hope that these sectors would do better this year.

Finance and energy should lead the way. Real estate is always a good inflation hedge. Technology should do well, but the president-elect has shown hostility to this sector and its leaders. He personally does not use a computer and says computers confuse things. Forty percent of new companies in Silicon Valley have been started by immigrants, but the president-elect has voiced opposition to immigration. Furthermore, he wants companies to make their products in the U.S., even though their infrastructure, logistics and many of their markets are in foreign countries.

Labor-intensive manufacturing jobs are disappearing in the U.S., it is true. This tends to impact men ages sixteen and over with a high school education or less. Building fences or building walls will not change that, but will indeed cause more to lose jobs. Indeed, China and other exporters to the U.S. are also increasingly automating their manufacturing, as their cost of labor increases. A more skilled work force, not walls, will provide the employment of the future.

Remain diversified and invested.

Best wishes for the new year, and the new era.

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